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MEMORANDUM FOR: Director of Economic Research

THROUGH

FROM

SUBJECT : Contribution to DCI Briefing Package for New
Administration

Attached for submission to Presentation Staff, OCI is the section of the briefing package dealing with the Soviet economy. It has been coordinated within OER and with OSR. Graphics have been arranged for.

The text follows along the lines of that used for the January 1968 Congressional briefings and will require revision and updating for the 1969 exercise after we get the 1969 budget and plan announcements in December.

Enclosure:

As stated above

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DCI Briefing for New Administration, November 1968

THE SOVIET ECONOMY

- I. The economy of the Soviet Union currently presents a mixed picture in which today's gains have been bought at the expense of tomorrow's problems.
- A. As I have already noted, the economy is supporting the highest peace-time military spending level in history.
 - B. The growth rate for gross national product has turned up a little.
 - C. Harvests of the past three years have been good to excellent.
 - D. The Soviet consumer has enjoyed more goods in the stores, more money in his pocket to buy them, and the promise of still further increases in his real income over the next two years.
 - E. These plus signs, however, have been accomplished in part by good weather--which cannot be counted on every year--and more importantly, by skimping on the investments essential to continued progress in both agriculture and industry.

(CHART, RATES OF GROWTH OF GNP, INDUSTRY AND AGRICULTURE)

- II. During the past two years, the Soviet economy picked up a little momentum following the slowdown in the preceding five years. Gross national product increased by almost 6 percent annually during 1966 and 1967, compared with 5 percent from 1961 to 1965. In 1968 Soviet GNP will probably increase by about $5\frac{1}{2}$ percent. Even so, however, the Soviet economy has not regained the high growth rates it had during the 1950's.

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- A. The higher growth of the past 3 years was due in part to the improved performance in agriculture.
 - 1. In 1966 and 1968 the USSR harvested the largest grain crops in its history, and a slightly better than average crop also was harvested in 1967. Grain output in these three years averaged more than a fifth above the average for the first half of the decade.
 - 2. Greatly increased supplies of fertilizer, plus higher prices paid to farmers, contributed to this surge in output of grain and other farm products, but good weather was the most important factor.
- B. The rate of growth of industrial production picked up moderately in 1966 and 1967. It averaged a little over 7 percent, compared with $6\frac{1}{2}$ percent from 1961 to 1965. Industrial growth appears to be sagging again in 1968, however. The rates for the 1960's are well below those achieved in the 1950's.
 - 1. A substantial part of industry's higher growth in 1966 and 1967 was due to the larger supplies of agricultural raw materials resulting from the good crops.
 - 2. Also important was the fact that many of the plants hastily built and commissioned under Khrushchev's regime finally started producing somewhere near capacity.

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(CHART, U.S. AND SOVIET GROSS NATIONAL PRODUCT)

III. Soviet GNP grew faster than U.S. GNP in 1966 and 1967 and should do so again in 1968. Nevertheless the Soviet economy is still less than half the size of ours, and the absolute gap between our GNP and theirs continues to widen.

A. As you may know, they allocate their total output differently from the way we do. Their allocations stress the elements of national power.

1. In dollar values, Soviet spending for defense is about four fifths of ours, and Soviet outlays for new fixed capital are about three-quarters of ours.
2. When it comes to consumption, a Soviet population that is almost one fifth larger than ours gets only one third of what is spent for consumption here.

(CHART, RATES OF GROWTH OF CONSUMPTION, DEFENSE AND INVESTMENT)

IV. The USSR has made some significant changes in the allocation of its total output in 1966-68.

A. A larger share of GNP went to the marshals. Defense expenditures rose 7 percent annually in 1966-67, three times as fast as in the preceding five years, and are continuing to rise in 1968.

1. Spending for advanced weapons and space systems--and especially for research and development--is growing two or three times as fast as total defense outlays.

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2. This creates a severe drag on the whole economy. These programs siphon off the most highly skilled engineers and scientists. They have first call on scarce strategic materials, sophisticated electronics and the most advanced industrial processes. These are the very kind of resources that the rest of the economy needs to modernize and to assure rapid technological development.

B. Consumers fared much better than before.

1. More and better quality food became available because of the improvement in agriculture.
2. There were also substantially larger supplies of clothing and of consumer durables, particularly washing machines and TV sets.

C. Investment in industry and agriculture was slighted.

1. The rate of growth of investment in industry dropped by one third from the already low rates of 1961 to 1965.
2. Investment in agriculture also grew much more slowly than in the earlier period. The rate was only half that scheduled in Brezhnev's big program to get agriculture out of the doldrums.

(CHART, PRODUCTION OF MACHINERY AND WEAPONS)

D. This diversion of resources away from investment in industry and agriculture shows up especially clearly when we compare the growth rates of machinery production with those for weapons production.

1. In 1966 and 1967, production of military equipment increased one and a half times as fast as production of machinery and equipment for civilian purposes.
2. So, for the moment at least, investment in the basic producing sectors--the key to future growth of the economy--clearly has yielded priority to the marshals and to consumers.

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V. Recent Soviet announcements suggest that these general policies are continuing.

A. This was implicit in the announced 15 percent increase in the defense budget for 1968 and an 11 percent increase in the budget for science, which includes substantial amounts of military R and D expenditures.

B. Although the data are very meager indeed, investment in industry and agriculture may not grow any faster from now to 1970 than it did in the past three years.

C. Consumers will continue to gain in 1969-70.

1. The effects of large increases in minimum wages and other welfare programs introduced during 1968 will be felt fully in 1969.

2. Per capita real income is scheduled to go up by about $8\frac{1}{2}$ percent annually in 1969 and 1970.

3. Goals for large increases in production of automobiles, television sets, refrigerators and other consumer durables have been retained.

D. Not all of these golden promises are likely to be fulfilled. I must also note that even if they are carried out, the lot of the Soviet consumer will still not be enviable by Western standards.

1. The average citizen will continue to live in cramped and crowded quarters. Per capita housing space won't even have reached the level that the Soviets themselves have set as the minimum for health and decency --9 square meters per capita.

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2. Availabilities of such things as television sets and refrigerators still will be below those in the U.S. and Western Europe.
3. The people's diet will still be loaded with bread and potatoes instead of the meat and dairy products they would like.
4. Queues and shoddy goods still will be a daily trial and tribulation.
5. Only a trickle of automobiles will be made available for private use. Even if 1970 goals are met, the USSR will have only half as many automobiles per capita as Greece does now. A Czech or an East German now has a better chance of owning a car than does a Soviet citizen.

VI. By favoring defense and being niggardly with investment, the Soviets are risking another slowdown in economic growth like that of the early 1960's.

If present priorities are maintained, here is the outlook:

- A. Expansion and modernization of the industrial plant will have to slow down. The over-all technological level of Soviet industry will lag even further behind the West than it already does.
- B. Agriculture will not be getting the machinery, quality fertilizer, and funds for land improvement that it needs to ensure stable growth.
 1. You will recall that from 1963 to 1965 poor harvests forced the USSR to spend more than \$1.5 billion of its scarce gold reserves to import wheat.
 2. Agriculture will remain grossly inefficient in comparison with Western countries. It now uses more than a third of the total labor force.

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- C. Consumers may not get all the goods and services to match the money income gains they have received.
1. Cutbacks in investment in industry mean that ultimately production of consumer goods will be affected.
 2. Cutbacks in investment allocations to agriculture jeopardize the chances for more quality foods like meat and milk.
- D. Looking ahead only over the next two years, that is, to 1970, which is the last year of the current five year plan, we think that the overall growth of GNP is likely to fall back somewhat from the average achieved in 1966-68.
1. A critical factor will be the weather for agriculture.
Exceptional weather cannot be counted on to produce good harvests every year.
 2. After a slowdown in 1968, the growth of industrial production in 1969-70 may or may not regain the unspectacular rate achieved in 1966-67. An important factor here will be in the impact of the economic reform that they are now carrying out. Initially it seems to be having a temporary beneficial impact on productivity. The reforms are not very far-reaching, however, and in our judgment they will not cure the long-standing ills of the Soviet system of economic management.
 3. Another key factor will be the future trend in defense spending.

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4. Ultimately, however, the large cutback in investment in the past few years is bound to affect economic growth adversely. Some of the Soviet leaders already recognize this. Indeed, how best to allocate the USSR's limited resources seems to be a hot issue in the Kremlin at the moment.

(CHART, SOVIET FOREIGN TRADE)

- VII. The USSR's foreign trade continued to grow rapidly in 1966-68 and its hard currency position improved markedly.
 - A. About two thirds of Soviet foreign trade is with Communist countries, and one third with the Free World.
 1. Since 1960, trade with Western industrialized countries has increased rapidly as the USSR has sought to upgrade the quality of its industrial plant by importing equipment and technology.
 2. Soviet trade with the less developed countries has tended to stagnate in the past several years. Much of this trade depends on Soviet willingness to extend aid.
 3. The USSR's trade with China has continued to decline and has now fallen to a mere \$100 million, compared with more than \$2 billion in 1959.
 - B. The USSR's hard currency position improved dramatically in 1967 and continues to be favorable in 1968. Gold reserves have risen accordingly.
 1. Because of chronic difficulties in finding products that Western countries will buy, the USSR for many years had a hard currency deficit with the West. The Soviets had to sell gold and also to

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seek credits to pay for needed imports. In 1967, however, they managed to increase exports and to reduce imports substantially, thus achieving their first hard currency surplus in nearly 10 years. It amounted to about \$100 million and should be about the same in 1968.

(CHART, SOVIET GOLD RESERVES)

2. On account of the bad crop years in 1963 and 1965, the USSR was forced to sell large amounts of gold to pay for emergency imports of wheat and also for machinery. As a result, its gold reserve dropped from more than \$2 billion in 1962 to about \$1 billion in 1965.
3. The USSR has sold almost no gold since 1965, and its gold reserves should be over \$1.4 billion by the end of this year.
4. The USSR now produces about \$200 million in gold each year. Despite very high production costs, the Soviets are carrying out a program of expanding the industry at about 7 percent annually.

VIII. The USSR has continued to dispense foreign aid -- both economic and military -- to its Communist allies as well as to Free World less developed countries.

- A. Total Soviet economic aid was about \$1.8 billion in 1966 but dropped off to about a half billion dollars in 1967. Economic aid to Communist countries in 1967 was about \$400 million -- down about \$100 million from 1966 -- and was divided about 50-50 between North Vietnam and Cuba. In 1968 total Soviet economic aid has risen to about \$1 billion, with more than \$700 million going to the Communist countries. Aid to North Vietnam is running a little above last year.

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B. Total Soviet military aid in 1967 was about \$1.1 billion, up from roughly \$700 million in 1966. Military aid in 1967 was split almost equally between the Communist countries (mainly North Vietnam) and the Free World less developed countries. Military aid to the less developed countries in 1968 is down by perhaps two-thirds from the total committed in 1967. Military aid to Communist countries (mostly to North Vietnam) is running at roughly the same rate as in 1967. I shall go into more detail concerning Communist aid to North Vietnam when I deal specifically with the war in Vietnam.

(CHART, SOVIET FOREIGN AID ACTIVITY IN THE FREE WORLD)

D. Now I want to discuss Soviet economic and military aid to countries in the Free World. There are as yet no signs that the preoccupation with resource allocation problems at home is leading the Soviets to curtail the program of economic and military aid to Free World countries.

1. In 1966 the USSR extended a record of almost \$1.3 billion in economic aid. More than \$500 million of this represented a commitment to support India's five-year plan. Large credits were also granted to Iran, Syria, and Brazil.
2. In 1967 extensions of economic aid dropped sharply, to about \$90 million and recovered to only about \$300 million in 1968. This is only about half of the average annual amount extended in the

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preceding 8 years. The reduced level of new aid undertakings in 1967 and 1968 apparently represents a lack of suitable opportunities rather than a change in policy. At the end of 1967 there was about \$3.5 billion of Soviet aid still to be delivered under aid extended in previous years.

3. The Soviets do seem to be getting a bit tougher with their aid.

- a. They are being more selective with the kinds of projects undertaken, so as to ensure a greater degree of success.
- b. Terms of the credits are becoming more trade-oriented and often are harder--5 to 10 years for repayment instead of the customary 12, and an interest rate of 3 to 3.5 percent, instead of 2.5 percent. Occasionally down payments are required, and repayments sometimes must be made partly in hard currency.

D. Extensions of Soviet military aid have fluctuated widely from year to year, reaching a record of almost \$1 billion in 1964. The annual average over the past decade, however, has been about \$450 million.

1. The \$535 million of military aid extended in 1967 reflected the heavy Soviet resupply operations in the UAR, Iraq and Syria following the Arab-Israeli war in June. New aid extended to these 3 countries accounted for almost 60 percent of the total. Earlier in the year, an arms agreement was signed with Iran, the first one Iran had signed with a Communist country. Agreements also were concluded with Nigeria and Yemen, and military goods were airlifted to these countries.

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2. Military aid agreements have been concluded with at least 6 countries during 1968. Although the total value of these agreements is not known, it is probably no more than one-third of the total committed in 1967.
- E. Soviet deliveries of military equipment declined in 1968 as supply to Arab countries assumed a more normal rate.
1. During and immediately after the June war, the USSR rushed huge supplies of military equipment to the Arab countries. With the near completion of resupply, Soviet deliveries have fallen off and now approximate the pre-war rate.
 2. We believe that the USSR has replaced at least 90 percent of the estimated \$450 million worth of military equipment destroyed or lost during the war with Israel. Continued supply probably will provide for modernization and some increase in the overall level of Arab inventories beyond the June 1967 level.
 3. Soviet deliveries to other major arms customers this year include significantly larger amounts to India (principally SU-7 fighter bombers) and small shipments to both Algeria and Afghanistan.

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